DEPARTMENT OF STATE REVENUE

04-20120287.LOF

Letter of Findings: 04-20120287
Use Tax
For Tax Years 2007-2009

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ISSUES

I. Use Tax – Restaurant Purchases.

Authority: IC § 6-2.5-5-3; IC § 6-2.5-5-6; IC § 6-2.5-5-35; 45 IAC 2.2-5-14.

Taxpayer argues that it was not subject to use tax on various restaurant items.

II. Use Tax – Consumables Used in Lodging.

Authority: IC § 6-2.5-5-35.

Taxpayer asserts that it was not subject to use tax on items that it claims were consumables used in hotel rooms.

III. Use Tax – Repair and Replacement Parts.

Authority: 45 IAC 2.2-5-8.

Taxpayer asserts that it was not subject to use tax on certain items because the items were used in the direct production of tangible personal property.

IV. Use Tax – Maintenance Contracts.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-5-3; IC § 6-8.1-5-1; IC § 6-8.1-3-3; 45 IAC 2.2-4-2; Carroll County Rural Elec. Membership Coop. v. Dep't of State Revenue, 733 N.E.2d 44 (Ind. Tax Ct. 2000); Sales Tax Information Bulletin 2 (May 2002); Sales Tax Information Bulletin 2 (December 2006); Letter of Findings 05-0438 (August 11, 2006).

Taxpayer protests the imposition of use tax on equipment and software maintenance contracts.

V. Use Tax – Delivery Charges.

Authority: IC § 6-2.5-1-5.

Taxpayer protests the imposition of use tax on delivery charges for items it claims are exempt from use tax.

VI. Use Tax – Royalties.

Authority: IC § 6-2.5-1-5; IC § 6-2.5-4-1.

Taxpayer protests the imposition of use tax on what it claims are slot machine royalties.

VII. Use Tax – Complimentary Merchandise.

Authority: IC § 6-2.5-3-2; IC § 6-2.5-3-4; Horseshoe Hammond, LLC v. Indiana Dep't of State Revenue, 865 N.E.2d 725 (Ind. Tax Ct. 2007).

Taxpayer protests that it self-assessed use tax on the incorrect value of tangible personal property.

STATEMENT OF FACTS

Taxpayer is a company operating a casino in Indiana. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit. As a result of the audit, the Department assessed use tax against Taxpayer. Taxpayer protested the assessment. As part of its protest, Taxpayer filed a Claim for Refund, GA-110L, for various claimed overpayments. An administrative hearing was conducted during which Taxpayer explained the basis for its protest. This Letter of Findings results.

I. Use Tax – Restaurant Purchases.

DISCUSSION

Taxpayer protests the imposition of Indiana use tax on various items used in food preparation and in food delivery.

The first set of items Taxpayer protests is various cooking items. In its protest, Taxpayer lists "an oven drip tray, cutting boards, pizza pans, mixing bowls, bamboo steamers, stainless inserts pans, non-stick frying pans, stainless steel food pans, and a conveyor toaster." Taxpayer also lists a tank and cylinder for supplying carbon dioxide for beer and carbonated beverages.

IC § 6-2.5-5-3(b) states:

> Except as provided in subsection (c) [relating to electricity distribution and transmission equipment], transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

Further, IC § 6-2.5-5-35(a) states:

> Except as provided in subsection (b), transactions involving tangible personal property are exempt from the state gross retail tax if:
>
> (1) the:

(A) person acquires the property to facilitate the service or consumption of food and food ingredients that is not exempted from the state gross retail tax under section 20 of this chapter; and
(B) property is:
(i) used, consumed, or removed in the service or consumption of the food and food ingredients; and
(ii) made unusable for further service or consumption of food and food ingredients after the property's first use for service or consumption of food and food ingredients[.]

Of the items listed, the oven drip tray, cutting boards, pizza pans, mixing bowls, bamboo steamers, stainless inserts pans, non-stick frying pans, and stainless steel food pans do not act directly upon the food item. Instead, the heat from stoves and other heating appliances act upon the food to produce other tangible personal property. Thus, Taxpayer has not established that it is entitled to an exemption under IC § 6-2.5-5-3 for production of food with regard to these items. Further, Taxpayer has not established that the items are rendered unusable after the items' first use, which is required for exemption under IC § 6-2.5-5-35(a)(1).

With regard to the "conveyor toaster," Taxpayer has provided sufficient factual grounds to demonstrate how the conveyor toaster is directly used in the direct production of other tangible personal property. Thus, Taxpayer's protest is sustained with regard to the conveyor toaster.

With regard to the carbon dioxide for carbonated beverages, Taxpayer has demonstrated that the carbon dioxide is used to convert syrup and water into a consumable beverage. As such, the carbon dioxide is directly consumed in the direct production of consumable beverages within the meaning of IC § 6-2.5-5-6. However, in order to qualify for a manufacturing exemption, Taxpayer must sell the beverages in question. See 45 IAC 2.2-5-14(b).

However, Taxpayer has not established that the carbon dioxide tanks are directly used in direct production and thus Taxpayer is denied with regard to the tanks. Further, with regard to the nitrogen used in beer, Taxpayer has not established that the nitrogen is directly used in the direct production of other tangible personal property.

FINDING

Taxpayer's protest is denied except for the toaster oven and carbon dioxide gas used in soft drinks sold by Taxpayer.

II. Use Tax – Consumables Used in Lodgings.

DISCUSSION

Taxpayer protests the Department's assessment of use tax on items it claimed were used or consumed by a guest's first use during occupation of hotel rooms. In particular, Taxpayer protests a list of items from one vendor.

IC § 6-2.5-5-35 provides in relevant part:

(a) Except as provided in subsection (b), transactions involving tangible personal property are exempt from the state gross retail tax if:

. . .

(2) the:
(A) person acquiring the property is engaged in the business of renting or furnishing rooms, lodgings, or accommodations in a commercial hotel, motel, inn, tourist camp, or tourist cabin; and
(B) property acquired is:
(i) used up, removed, or otherwise consumed during the occupation of the rooms, lodgings, or accommodations by a guest; or
(ii) rendered nonreusable by the property's first use by a guest during the occupation of the rooms, lodgings, or accommodations.

In this case, Taxpayer has provided one vendor's invoices for the items Taxpayer is protesting. Taxpayer has provided sufficient information to demonstrate that it uses items such as lotions and soaps in its lodgings and that the items are consumed or otherwise rendered unusable by guests during the occupation of rooms. Taxpayer's protest is sustained.

FINDING

Taxpayer's protest is sustained.

III. Use Tax – Repair and Replacement Parts.

DISCUSSION

Taxpayer protests the imposition of use tax on replacement parts. In particular, Taxpayer protests that the parts in question were used on exempt equipment and therefore the replacement parts themselves are exempt from sales and use tax.

The issue is twofold. The first issue is whether an exemption applies to a replacement part used on exempt equipment. The second issue is whether the underlying equipment itself is exempt.

Under 45 IAC 2-2.5-8(h)(2), replacement parts for production equipment qualify for sales and use tax exemption. This exemption would apply to the extent the machinery in question is used in production, similar to the examples of computers and other partially exempt and partially taxable items listed in 45 IAC 2.2-5-8(c) and (g). Thus, if a range or stove is seventy percent exempt, a replacement part is seventy percent exempt.

For this issue, Taxpayer has not provided sufficient information to conclude that the equipment in question was exempt. Therefore, Taxpayer has not established that the replacement parts for that equipment were exempt.

FINDING

Taxpayer's protest is respectfully denied.

IV. Use Tax – Maintenance Contracts.

DISCUSSION

Taxpayer protests the imposition of use tax on maintenance contracts. The issue is whether the various protested maintenance contracts were properly subject to Indiana sales and use tax.

A. Equipment Maintenance Contracts

The first type of maintenance contract is for items other than computer software.

The Department's audit imposed sales tax on Taxpayer's sales of optional/extended warranty contracts. Taxpayer, to the contrary, asserted that it was not responsible for sales tax on its sales of the optional/extended warranties.

The prior version of Sales Tax Information Bulletin 2 stated as follows:

> Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax. Any parts or tangible personal property supplied pursuant to this type of agreement are subject to use tax. Sales Tax Information Bulletin 2 (May 2002), 25 Ind. Reg. 3595.

However, a later version of Sales Tax Information Bulletin 2 upon which the Department's audit relied stated as follows:

> Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are subject to sales tax if there is a reasonable expectation that tangible personal property will be provided. Any parts or tangible personal property supplied pursuant to this type of agreement are not subject to sales or use tax. Sales Tax Information Bulletin 2 (December 2006), 20100804 Ind. Reg. 045100497NRA, (Effective August 4, 2010).

Because of the delayed publication of Sales Tax Information Bulletin 2 (December 2006), the Department's guidance and interpretation on this issue relevant to the years for which Taxpayer was audited is found in Sales Tax Information Bulletin 2 (May 2002) which states that "Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax." Id. Therefore, Taxpayer was not required to remit sales or use tax on the warranties/maintenance agreements it purchased during the audit period.

The audit division is requested to review the original assessment of tax on the sale of warranties/maintenance agreements to its customers based on Sales Tax Information Bulletin 2 (May 2002) in effect during the audited years and to make whatever adjustment is appropriate. Taxpayer shall provide a copy of the relevant maintenance agreements to the Department's Audit Division no more than thirty (30) days after this Letter of Findings is issued. If Taxpayer does not provide the agreements to the Department within this time period, Taxpayer's protest is denied.

Taxpayer also raised an alternative contention that the maintenance contracts are for equipment use for exempt purposes under IC § 6-2.5-5-3. To the extent Taxpayer's protest relates to exempt equipment, Taxpayer's protest is sustained even if the maintenance agreement would otherwise be taxable under Sales Tax Information Bulletin 2 (May 2002).

B. Software Maintenance Contracts

The second type of maintenance contract is computer software maintenance agreements. Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

Taxpayer purchased various software "maintenance agreements." During the audit, the Department found instances where Taxpayer had purchased software "maintenance agreements" without paying sales tax at the time of purchase, and assessed use tax on the purchases.

Taxpayer maintains that since the software "maintenance agreements" do not contain a provision which guaranteed that Taxpayer would automatically receive software updates and upgrades, the software "maintenance agreements" are not subject to Indiana sales/use tax.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b).

In support of its position that the transactions are not subject to sales/use tax, Taxpayer points to 45 IAC 2.2-4-2(a) which states:

> Professional services, personal services, and services in respect to property not owned by the person rendering such services are not "transactions of a retail merchant constituting selling at retail", and are not subject to gross retail tax....

The 2002 version of Sales Tax Information Bulletin 2 did not require the vendor to collect sales tax on the sale of the extended warranties and maintenance agreements; however the vendor was required to self-assess use tax on any parts supplied pursuant to the terms of the warranty or agreement. The 2006 version of Sales Tax Information Bulletin 2, effective in August 2010, essentially reversed that requirement. The vendor was required to

collect sales tax on the sale of the warranty but was not required to self-assess use tax on any parts supplied pursuant to the terms of the warranty.

However, the Department must point out that prior to the issuance of the Sales Tax Information Bulletin 2 (December 2006) in August 2010, the Department issued Letter of Findings 05-0438 (August 11, 2006), 20061101 Ind. Reg. 045060474NRA, in which the Department addressed the question of whether "Software Maintenance Agreements" were subject to sales tax. The Department found that these agreements were subject to sales tax on a "prospective basis" as follows:

> There is no regulation that sets out the department's position regarding the application of sales and use tax to optional warranties. The department first issued Sales Tax Information Bulletin [] 2 concerning Optional Warranties... on May 2, 1983. In that Information Bulletin, the department explained that if there was a possibility that no tangible personal property would be transferred with the warranty, then there was no certainty that there would be a retail sale and the sales and related use tax did not apply. This position was restated in the revised Sales Tax Division Information Bulletins issued in August 1991, November 2000, and May 2002. Each of the revisions restated the general rule. In the May 2002 revision, it was stated "[o]ptional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax." Each of the revisions also gave a specific example concerning computer software situations. The examples stated that sales and use tax would apply to the sale of an optional warranty or maintenance agreement in the software situation only if there was a guarantee of the transfer of tangible personal property (updates) pursuant to the agreement.
>
> Computer technology and use has evolved since the issuance of the first Sales Tax Information Bulletin [] 2 on May 2, 1983. Almost all software optional warranties and software maintenance agreements sold today include the automatic provision of updates-sometimes on a day-by-day or week-by-week basis. Purchasers of these agreements have a reasonable expectation that they will receive the updates whether or not the actual contract couches the provision of updates as "optional." The substance of the agreements is that tangible personal property in the form of software updates will be provided no matter what the language of the contract says. The department determines tax consequences by construing the substance of the agreement over the form. Wholesalers, Inc. v. Indiana Department of State Revenue, 597 N.E.2d 1339 (Ind. Tax 1992). In the case of software maintenance agreements or optional warranties, it is clear that the parties presume that tangible personal property in the form of updates will be transferred. Therefore, **the department will construe software maintenance agreements and optional agreements as presumed to be subject to the sales and use tax.** A taxpayer could rebut this presumption by demonstrating that no updates were actually received pursuant to a particular maintenance agreement or optional warranty.
>
> In this particular taxpayer's situation, the department will apply this interpretation prospectively. (Published in the Indiana Register and available at http://www.in.gov/legislative/iac/20061101-IR-045060474NRA.xml.html) (**Emphasis added**).

As of the publication of Letter of Findings 05-0438 the Department fulfilled its obligation to give notice of its "change of interpretation" concerning the taxability of software maintenance agreements. As summarized in the Letter of Findings, "The taxpayer's protest is sustained as to the maintenance agreements and optional warranties in this assessment. The taxpayer is advised that in the future, there will be a rebuttable presumption that all software maintenance agreements and optional warranties will be subject to the sales and use taxes."

In the case of the software maintenance agreements, the interpretations set out in the Sales Tax Information Bulletins are irrelevant. Instead, the interpretation set out in the August 2006 Letter of Findings governs the issue. The publication of that Letter of Findings met the publication requirements set out in IC § 6-8.1-3-3. See Carroll County Rural Elec. Membership Coop. v. Dep't of State Revenue, 733 N.E.2d 44, 49 n.5 (Ind. Tax Ct. 2000) ("The publication of the Letter of Findings is a prerequisite for the Department before it can change its position as to the interpretation of a tax, where the change would increase the taxpayer's liability.").

Taxpayer has provided information that, according to Taxpayer, demonstrates that the software maintenance contract was for support services only and that no tangible personal property is provided. Taxpayer states "[representative] confirmed by calling the vendor that the purchase of the software maintenance was for support only." Absent a written statement from the vendor or information such as web pages from the vendor's website, the Department lacks sufficient legal and factual grounds to conclude that the transaction should not have been subject to Indiana use tax.

FINDING

Taxpayer's protest is sustained subject to audit review on hardware maintenance contracts. Taxpayer's protest is denied with regard to software maintenance contracts.

V. Use Tax – Delivery Charges.

DISCUSSION

Taxpayer protests the imposition of use tax on certain delivery charges. In particular, Taxpayer protests that it purchased items exempt from Indiana sales and use tax and, along with the items, incurred delivery charges. The issues are twofold. The first issue is whether the delivery charges are exempt when the delivery charges are for the delivery of tax exempt items. The second issue is whether the items on which the assessment for delivery

charges was based were in fact exempt from sales and use tax.

In general, IC § 6-2.5-1-5(a)(4) treats "delivery charges" as gross retail income. However, if the tangible personal property is exempt, the relevant exemption extends to the entire purchase price–the "gross retail income"–associated with the item, including delivery charges.

With regard to the actual exemption for the items in question, Taxpayer has not provided sufficient information to conclude what the exempt use of the property was. Taxpayer's protest is denied.

FINDING

Taxpayer's protest is respectfully denied.

VI. Use Tax – Royalties.

DISCUSSION

Taxpayer protests the imposition of use tax on what it describes as "royalties." Taxpayer leases various slot machines from third parties. As part of the lease with the third parties, Taxpayer pays a monthly fee along with a daily royalty fee. The issue is whether the daily royalty fee–separately stated from the monthly fee–is part of the lease stream for the tangible personal property.

In general, IC § 6-2.5-1-5 provides that gross retail income "means the total amount of consideration, including cash, credit, property, and services, for which tangible personal property is sold, leased, or rented, valued in money, whether received in money or otherwise, without any deduction for [ ]." In addition IC § 6-2.5-4-1(e) states:

> The gross retail income received from selling at retail is only taxable under this article to the extent that the income represents:
>
> (1) the price of the property transferred, without the rendition of any service; and
>
> (2) except as provided in subsection (g), any bona fide charges which are made for preparation, fabrication, alteration, modification, finishing, completion, delivery, or other service performed in respect to the property transferred before its transfer and which are separately stated on the transferor's records.
>
> For purposes of this subsection, a transfer is considered to have occurred after delivery of the property to the purchaser.

In this particular case, Taxpayer provided a copy of the purchase order for various games. Page three of the purchase order states: "[Third-party Brand] royalty fees are due & payable in conjunction with the sale of [Third-party Brand] video products. These fees are payable by [Vendor] to [Third party] in accordance with the terms of the applicable trademark licensing agreement and no portion of these fees is retained by [Vendor]."

In this case, Taxpayer has provided sufficient information to conclude that the royalties paid with regard to games and which were entirely remitted to a third-party vendor did not represent the sale of tangible personal property or of any taxable transaction under IC § 6-2.5-4. Taxpayer is sustained with regard to any royalties for games which were in turn entirely remitted to a third-party vendor. With regard to any other amounts claimed to be royalties, Taxpayer has not provided sufficient legal or factual grounds to conclude that these amounts represented anything other than lease payments for tangible personal property.

FINDING

Taxpayer's protest is sustained to the extent provided above.

VII. Use Tax – Complimentary Merchandise.

DISCUSSION

Taxpayer states that it self-assessed Indiana use tax on tobacco that it gave away as a complimentary item. However, Taxpayer states that it self-assessed the tax on its retail value of the tobacco. Instead, Taxpayer asserts that it should have self-assessed the tax on the value at which Taxpayer purchased the tobacco. In other words, if Taxpayer purchased tobacco at three dollars but would have resold the tobacco at five dollars, Taxpayer self-assessed use tax and remitted use tax on the five dollar retail value. Taxpayer now asserts that the three dollar purchase price was the proper measure of Indiana use tax.

IC § 6-2.5-3-2 imposes a use tax on the "storage, use, or consumption of tangible personal property in Indiana" acquired at retail. IC § 6-2.5-3-4(b) provides that, if property was previously acquired exempt from use tax but the property is subsequently used for a nonexempt purpose, the property is then subject to use tax. For instance, if a company purchased merchandise for resale–and therefore exempt from Indiana sales and use tax–and then used the property for its own purposes (e.g., a promotional giveaway), the company would then be subject to Indiana use tax once the property is used for its own purposes.

In addition, the Indiana Tax Court held in Horseshoe Hammond, LLC v. Indiana Dep't of State Revenue, 865 N.E.2d 725, 730 (Ind. Tax Ct. 2007), that "[Horseshoe Hammond] was required to remit use tax on its complimentary merchandise based on the price by which it acquired the merchandise from its suppliers."

Taxpayer has provided sufficient legal grounds to determine that the proper measure of use tax for complimentary merchandise is Taxpayer's own purchase price. However, the amount of refund, or assessment offset, is subject to review by the Department's Audit Division.

FINDING

Taxpayer's protest is sustained subject to audit review.

CONCLUSION

1. Taxpayer is denied on issue I except with regard to the toaster oven and carbonated gases used in soft drinks sold in its operations.
2. Taxpayer is sustained with regard to complementary items consumed in its hotel rooms.
3. Taxpayer's protest is denied with regard to repair parts.
4. Taxpayer's protest is sustained on hardware maintenance agreements subject to audit verification. Taxpayer's protest is denied with regard to software maintenance agreements.
5. Taxpayer's protest is denied with regard to delivery charges.
6. Taxpayer's protest is sustained with regard to separately-stated and billed royalty fees which are paid at cost by a game maker to an unrelated third party.
7. Taxpayer's protest is sustained subject to audit verification with regard to the overpayment of use tax.

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